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BEFORE THE ARIZONA CORP

308

COMMISSIONERS

JEFF HATCH-MILLER - Chairman  
WILLIAM A. MUNDELL  
MIKE GLEASON  
KRISTIN K. MAYES  
BARRY WONG

IN THE MATTER OF THE APPLICATION OF  
FAR WEST WATER AND SEWER COMPANY,  
AN ARIZONA CORPORATION, FOR A  
DETERMINATION OF THE FAIR VALUE OF  
ITS UTILITY PLANT AND PROPERTY AND  
FOR INCREASES IN ITS RATES AND  
CHARGES FOR UTILITY SERVICE BASED  
THEREON.

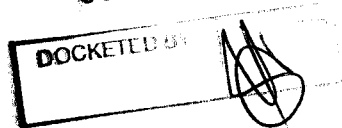
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**REPLY BRIEF OF  
COMMISSION STAFF**

The Staff of the Arizona Corporation Commission (the "Commission") ("Staff") hereby submits its Reply Brief in the above captioned matter. To the extent that Staff does not address an issue raised in the parties' closing briefs, Staff rests on its positions as discussed in its Closing Brief. However, Staff replies to certain matters discussed by Far West Water & Sewer Company (the "Company" or "Far West"). Staff, Far West and the Residential Utility Consumers Office ("RUCO") filed closing briefs on September 8, 2006. Staff hereby respectfully submits its Reply Brief in this matter.

Arizona Corporation Commission  
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1 **I. THE COMPANY SHOULD REVIEW AND FORMALIZE MANAGEMENT**  
2 **PROCEDURES FOR MANAGING OPERATIONS AND COMPLIANCE.**

3 In its Closing Brief, Far West claimed that past compliance problems "generally result[ed]  
4 from [1] rapid growth, [2] inadequate performance by independent contractors, and [3] the failure of  
5 the Company's previous management team to take adequate action to meet the demands of the  
6 customers."<sup>1</sup> Far West cited the testimony of Ms. Paula Capestro, its president, director and  
7 shareholder, as evidence to support its claim.<sup>2</sup> It also stated that "the Company's owners and current  
8 management have accepted responsibility for the situation and steps are being taken to resolve the  
9 problem."<sup>3</sup>

10 Ms. Capestro testified that "quite frankly, I think it's been [management's] lack of direct  
11 involvement with underlying field supervisors that's been the problem. I think we have relied on  
12 people that we thought were probably more qualified than us."<sup>4</sup> She explained that:

13 I am actively involved. Now rather than using a director of  
14 operations, everybody reports directly to me. There is one layer of  
15 management there that is gone.<sup>5</sup>....[U]ltimately I think the goal  
16 would be to organize this company in a little bigger structure, a  
little more of a - what is the right word to use - - standardized,  
bigger Company structure. It's moving from minor leagues to  
major leagues.<sup>6</sup>

17 Staff agrees with the goal of management being more directly involved in its sewer  
18 operations. Staff witness Mr. Jian Liu confirmed that the Company is currently in compliance with  
19 rules and regulations of the Arizona Division of Occupational Safety and Health ("ADOSH").<sup>7</sup> Mr.  
20 Liu also testified about the Company's wastewater treatment facilities.<sup>8</sup>

21 All of Far West's facilities are in non-compliance with one or more of the rules and  
22 regulations of the Arizona Department of Environmental Quality ("ADEQ").<sup>9</sup> Staff agrees with the  
23 current ADEQ process for achieving compliance for all of the facilities.<sup>10</sup> However, Staff continues

24 <sup>1</sup> Far West Closing Brief at 3, ll. 7-10.

25 <sup>2</sup> *Id.* at 10-11.

<sup>3</sup> *Id.* at 11-14.

26 <sup>4</sup> Tr. at 126, ll. 1-5.

<sup>5</sup> *Id.* at 54, ll. 21-23.

27 <sup>6</sup> *Id.* at 126, ll. 5-9.

<sup>7</sup> See Staff Closing Brief at 6, ll. 3-10 and 32, ll. 4-8.

28 <sup>8</sup> *Id.* at 32, ll. 15-18.

<sup>9</sup> Tr. at 87, ll. 6-9.

<sup>10</sup> *Id.* at 465, l. 3, to 466, l. 6.

1 to have concerns about management involvement and processes for critical sewer operations.  
2 Examples of Staff's concerns are reflected in the record.

3 The best example in the record is Far West's response to the fire at the Palm Shadows  
4 Wastewater Treatment Facility ("Palm Shadows").<sup>11</sup> Ms. Capestro testified on two different  
5 occasions that the Company has taken extra precautions for safety related to confined spaces. She  
6 specifically stated, "[W]e consider any space that someone goes into a confined space. Even though  
7 technically OSHA isn't that strict, we have taken that position."<sup>12</sup> Ms. Capestro further testified that:

8 [W]e are trying to show what can happen if you don't have a good  
9 confined space policy and how dangerous it is. And we are trying  
10 to not only teach every one of our operators how to practice safety  
11 - - it's one thing to teach safety; it's another thing to practice  
12 safety. They have to practice safety. And that's important to us.<sup>13</sup>

12 The Company's General Superintendent, Mr. Mark Kaveney, testified about the fire at Palm  
13 Shadows. Ms. Capestro explained Mr. Kaveney's role at the Company:

14 [Mr. Kaveney] is our eyes and ears in the field. He also talks to  
15 and takes care of customer complaints, safety. He is involved in  
16 overseeing safety, certification of his operators.<sup>14</sup> ....[Mr. Kaveney]  
17 handles [OSHA inspections]. We do have a safety director, a full-  
time safety director. And they are - they work hand-in-hand with  
OSHA.<sup>15</sup>

18 Mr. Kaveney reviewed the procedures followed by the operator on site when the fire occurred.

19 He testified that, "[The operator] did the right thing. When it flashed, he got out...For an  
20 incident, it went perfect."<sup>16</sup> Far West determined that the incident was not reportable to ADOSH  
21 because it was not a "substantial near miss." Mr. Kaveney explained that the operator's "life [was  
22 not] threatened or harmed."<sup>17</sup>

24 <sup>11</sup> Note that Staff's Closing Brief at 32, l. 5 misstated the date of the incident. The incident occurred on May 15, 2006,  
25 not May 15, 2005.

26 <sup>12</sup> Tr. at 78, ll. 21-24. See also Tr. at 83, ll. 18-22 ("And I think we have done everything that we could to see to it that a  
tragic accident like this does not happen again. That is my comment about -- every space is a confined space. We take  
it, the letter of the law, to the extreme.").

27 <sup>13</sup> Id. at 84, ll. 7-12.

27 <sup>14</sup> Id. at 91, ll. 2-5.

28 <sup>15</sup> Id. at 84, ll. 3-6.

<sup>16</sup> Id. at 143, ll. 20-24.

<sup>17</sup> Id. at 145, ll. 7-18.

1 Staff believes that the Company's testimony is inconsistent, and raises questions about how  
2 operators "practice safety." In response to a Staff data request, Mr. Kaveney responded, "That  
3 morning [of the fire], the Far West operator was performing daily operating routines. One such  
4 routine was to check the methanol room."<sup>18</sup> According to Ms. Capestro's testimony, the Company's  
5 policy is for operators to treat the methanol room as a confined space. Even though Mr. Kaveney  
6 testified that he reviewed the incident with the operator,<sup>19</sup> he did not know whether the operator was  
7 carrying his respirator and other safety equipment.<sup>20</sup>

8 Moreover, Mr. Kaveney did not adequately explain whether the operator followed the  
9 Company's safety procedures. Instead, he claimed that there was not a substantial near miss because  
10 "[p]eople are closer to fire when they light their barbecue pit than what happened in this building."<sup>21</sup>  
11 He also claimed that if methanol vapors ignited "you would [not] have that violent of an explosion."<sup>22</sup>  
12 Finally, Mr. Kaveney testified as follows:

13 Q. Is it your opinion then that he followed [appropriate]  
14 safe[ty] protocol to remain near the door to try to see if he  
15 could detect the source of the vapor leak rather than  
16 immediately distancing himself from the [facility]?

17 A. Yes. He opened the door. You have a room full of vapors.  
18 You back off a safe distance away; in case of a flash  
19 nobody would get hurt. If you can it's a good idea to see  
20 what's causing the leak. Because you have to know how to  
21 address the problem.

22 Unfortunately this thing flashed pretty quickly. But, yeah,  
23 we were able to inform the fire department when they  
24 arrived on the scene what was going on. As opposed to  
25 opening a door with vapors and just running across the field  
26 and all of a sudden this thing lights off, you have no  
27 information to tell the fire department whatsoever.<sup>23</sup>

28 In contrast to Mr. Kaveney's testimony, industry fact sheets state that "[a]ccumulations of  
vapors in confined spaces may explode if ignited, and containers filled with methanol may rupture

25 <sup>18</sup> Ex. No. S-13.

26 <sup>19</sup> Tr. at 147, l. 22, to 148, l. 1.

27 <sup>20</sup> *Id.* at 143, ll. 7-24. See also 29. C.F.R. § 1910.134, App. D (Defining emergency situation as: "Emergency situation  
means any occurrence such as, but not limited to, equipment failure, *rupture of containers*, or failure of control  
equipment *that may or does result in an uncontrolled significant release of an airborne contaminant*." (Emphasis  
added.)). This appendix also describes use of respiratory protection equipment.).

28 <sup>21</sup> *Id.* at 145, ll. 18-23.

<sup>22</sup> *Id.* at 142, ll. 8-16.

<sup>23</sup> *Id.* at 142, l. 17 to 143, l. 6.

1 violently if exposed to fire....”<sup>24</sup> Mr. Kaveney explained that methanol vapors are flammable only  
2 within a specific gas-to-air ratio.<sup>25</sup> He then acknowledged that when the operator opened the door,  
3 the ratio fell below the “UEL into the flammable range.”<sup>26</sup>  
4

5 Mr. Kaveney further testified that the Company no longer uses methanol. Instead, the  
6 Company uses the chemical MicroC, which “does the same thing as methanol but it has a flash point  
7 of 130 degrees.”<sup>27</sup> Mr. Kaveney stated that MicroC is “a lot safer.”<sup>28</sup>  
8

9 Staff believes that Far West management should review this incident in greater detail.<sup>29</sup> The  
10 Company should also review its procedures for ensuring management policies are properly  
11 implemented. Finally, Staff believes that the Company should review the incident with ADOSH  
12 through the voluntary consultation program. It should also review its safety procedures for handling  
13 MicroC and any other chemicals used in its operations.  
14

## 15 **II. THE COMMISSION SHOULD ADOPT A ZERO WORKING CAPITAL** 16 **ALLOWANCE.**

17 Staff believes that the record clearly establishes that Far West’s working capital allowance  
18 should be zero. Notwithstanding the evidence in the record, the Company continues to argue as  
19 follows:

20 Staff recommends zero working capital because that was what the  
21 Commission ordered in the last rate case for Far West’s water  
22 division. Brown SB (Ex. S-23) at 17. That decision was the result

23 <sup>24</sup> Attachment 1. Note that ADOSH administers 29 C.F.R. § 1910 in Arizona. The fact sheet was developed using  
several regulatory sources including OSHA.

24 <sup>25</sup> Tr. at 140, ll. 1-20 (Combustion may occur within a lower exposure limit (“LEL”) and an upper exposure limit  
25 (“UEL”).

26 <sup>26</sup> *Id.* at 141, ll. 1-8. Note that Mr. Kaveney never answered the question of how an operator could determine whether the  
vapors were within the flammable range. *Id.* at 140, ll. 16-20. See also 29 C.F.R. § 1910.146 (see use of atmospheric  
monitoring devices).

27 <sup>27</sup> *Id.* at 136, ll. 5-9.

28 <sup>28</sup> *Id.*

29 See e.g. Tr. at 81, ll. 11-18 (Commissioner Mayes: “I guess that’s my concern. I am hearing a general lack of brass  
and detail, and I hope to hear more, both from you and from your company, in terms of your grasp of details of what is  
going on with this company. One of the things that the attorney general found was, I think, a lack of attention to detail by  
the company which resulted in the tragic deaths of two people and harm to a third.”).

1 of a "black-box" settlement and hardly constitutes precedent in this  
2 case. Bourassa RJ (Ex. A-6) at 6.<sup>30</sup>

3 The Company misconstrues the basis of Staff's recommendation and the precedent cited by Staff.

4 As Staff pointed out in its Closing Brief, the decision cited by Ms. Brown is not the same  
5 decision cited by Mr. Bourassa.<sup>31</sup> Staff based its recommendation on Decision No. 60437, not  
6 Decision No. 62649. In Decision No. 62649, the Commission accepted a settlement that set cash  
7 working capital at zero. However, the settlement was a compromise on differences in the parties'  
8 lead lag studies. It was not based on any party's use of the formula method.<sup>32</sup>

9 More importantly, the Commission put the Company on notice in Decision No. 60437 about  
10 what it expected in future rate cases. The Commission ordered the Company to conduct a lead lag  
11 study in order to receive a cash working capital allowance. It also ordered cash working capital to be  
12 set at zero if the Company did not perform a lead lag study.<sup>33</sup>

13 The Company's request for a working capital allowance of \$127,647<sup>34</sup> is based on use of the  
14 formula method<sup>35</sup>. Therefore, the Company's request should be denied pursuant to Decision No.  
15 60437. Additionally, the Commission's long standing policy is that Class B utilities must conduct  
16 lead lag studies and cannot use the formula method.<sup>36</sup> Staff requests the Commission to enforce  
17 Decision No. 60437 and its policy for Class B utilities.

18  
19 **III. THE PURPOSE OF PIERCING THE CORPORATE VEIL IS TO CORRECT**  
20 **INEQUITIES, NOT TO PUNISH MISCONDUCT**

21 Far West disputes Staff's disallowance of \$147,525 for affiliate profit. Contrary to the  
22 Company's position, Staff does not view common ownership as a "sin"<sup>37</sup> or "some sort of pernicious  
23 scheme."<sup>38</sup> Ms. Brown testified, "As long as Far West's affiliate is reimbursed for the actual cost it  
24 incurs to provide services to Far West it will be made financially whole and can continue to provide

25 <sup>30</sup> Far West Closing Brief at 5, ll. 3-6.

26 <sup>31</sup> Staff Closing Brief at 21, ll. 18-24.

<sup>32</sup> Ex. No. S-17 at 3 (page 6 of the Decision).

<sup>33</sup> Decision 60437 at 22, ll. 9-11.

27 <sup>34</sup> Far West Closing Brief at 5, ll. 7-8.

<sup>35</sup> *Id.* at 4, ll. 25-26.

28 <sup>36</sup> See e.g. Decision Nos. 60437 (dated September 29, 1997), and 65350 (dated November 1, 2002).

<sup>37</sup> Far West Closing Brief at 5, ll. 9-15.

<sup>38</sup> *Id.* at 8, ll. 18-19.

1 for services to Far West in the same manner.”<sup>39</sup> Staff seeks to pierce the corporate veil, not to punish  
2 Far West for contracting with its affiliate. Piercing the corporate veil is necessary to prevent Far  
3 West was earning more than its allowed return on equity (“ROE”) through the use of an affiliate.

4 The doctrine of piercing the corporate veil is an equitable doctrine. Its purpose is not to  
5 punish misconduct as suggested by Far West. The Arizona Supreme Court has continuously held that  
6 the purpose of the doctrine is to serve the interests of justice.<sup>40</sup> The legal fiction of a corporate entity  
7 should not be used to shield another legal entity from financial liability for its business transactions.<sup>41</sup>  
8 Use of the doctrine to prevent financial injustice is not a punishment. Courts do not use the doctrine  
9 to impose fines. Courts use it to place financial responsibility on the appropriate legal entity.

10 Far West argues that the Commission should not pierce the corporate veil because there is “no  
11 evidence of fraud, misconduct, ‘injustice’ or impropriety.”<sup>42</sup> The Company claims that it has made a  
12 *prima facie* showing that the total costs paid to H & S Developers are reasonable.<sup>43</sup> Far West appears  
13 to conclude that there is no evidence of “injustice” because Staff did not prove that affiliate profits  
14 are unreasonable.<sup>44</sup>

15 Far West selectively cites case law to divert attention from the legal and factual issues raised  
16 by Staff. For example, the Company cites *Arizona Public Service Co. v. Arizona Corporation*  
17 *Commission*, 155 Ariz. 263, 746 P.2d 4 (App. 1987), reversed in part on other grounds, *Arizona*  
18 *Public Service Co. v. Arizona Corporation Commission*, 157 Ariz. 532, 760 P.2d 532 (1988). Far  
19 West claims that the case “strongly supports the treatment of corporations as separate entities.”<sup>45</sup> The  
20 court declined to pierce the corporate veil because there was no evidence of fraud, misconduct,  
21 injustice or impropriety in the case. However, the Court noted in *dicta* that the Commission may  
22 prohibit a parent corporation and its subsidiary utility from evading regulation by means of the  
23 affiliate relationship.<sup>46</sup>

24  
25 <sup>39</sup> Brown Surrebuttal at 12, ll. 13-15.

<sup>40</sup> *Walker v. Southwest Mines Development Company*, 52 Ariz. 403, 414-15, 81 P.2d 90, 95 (1938).

26 <sup>41</sup> *Keams v. Tempe Technical Institute, Inc.*, 993 F.Supp. 714, 724 (D.Ariz. 1997), quoting *Ize Nantan Bagowa, Ltd. v. Scalia*, 118 Ariz. 439, 577 P.2d 725, 729 (App. 1978).

27 <sup>42</sup> Far West Closing Brief at 8, ll. 6-8.

<sup>43</sup> *Id.* at 6, ll. 5-6; and 7, ll. 11-12.

28 <sup>44</sup> *Id.* at 6, ll. 6-10.

<sup>45</sup> Far West Closing Brief at 7, l. 20 to 8, l. 2.

<sup>46</sup> *Id.* at 155 Ariz. at 8, 746 P.2d at 267.



1 The Company also claims that it met its burden of production pursuant to *Turpen v.*  
2 *Oklahoma Corporation Commission*, 769 P.2d 1309 (Okla. 1989).<sup>47</sup> The Company suggests that  
3 *Turpen* merely requires an affirmative showing of reasonableness for the burden of production. Yet  
4 the case stands for much more. The case set out a more stringent standard for affiliate transactions.

5 The *Turpen* court expressly held, "The utility must produce evidence, for example, that it  
6 charged affiliates the same amount as it did arms-length buyers."<sup>48</sup> It also acknowledged  
7 *Southwestern Bell*, *supra*. The *Southwestern Bell* court held, "The reasonableness of the expense to  
8 the utility, for ratemaking purposes, will depend, among other factors, on whether the services  
9 provided themselves are necessary or beneficial to....ratepayers."<sup>49</sup> Inexplicably, the Company  
10 argues that "[t]he undisputed evidence in this case is that the amounts charged by H&S Developer  
11 [sic] are at or below market."<sup>50</sup>

12 Part of the Company's initial factual showing included unsupported oral testimony from Ms.  
13 Capestro. She testified that "H&S Developers competes in the Yuma market and undertakes  
14 construction projects for non-affiliated entities."<sup>51</sup> Surprisingly, Ms. Capestro did not identify any of  
15 the non-affiliates. The Company also did not produce any evidence of the costs charged to the non-  
16 affiliates as required by *Turpen*. In its Closing Brief, Staff addressed why other evidence presented  
17 by the Company does not establish fair market value for affiliate services.<sup>52</sup>

18 The Company also argued that part of the disallowed affiliate profit is actually overhead. Far  
19 West asserts that "Staff witness Brown claimed to have never seen the Company's supporting  
20 documentation."<sup>53</sup> The assertion is in direct conflict with the Company's response to data request  
21 CSB 3.2:

22 "H & S Developers does not keep detailed job costing records for  
23 its labor and equipment departments which take into account all  
24 associated costs and overhead. H & S Developers did not intend to  
make a profit on the labor and equipment at the rates charged. H &

25 <sup>47</sup> Far West Closing Brief at 5, ll. 19-24; and 6, ll. 5-6.

26 <sup>48</sup> *Turpen*, 769 P.2d at 1323, citing *Southwestern Bell v. State Corp. Com'n of Kan.*, 602 P.2d 131 (Kan.App. 1979), note  
27 27 at 136-37.

27 <sup>49</sup> *Id.* at fn. 38.

28 <sup>50</sup> *Id.* at 7, ll. 7-8.

<sup>51</sup> Far West Closing Brief at 7, ll. 6-7.

<sup>52</sup> Staff Closing Brief at 14, l. 4, to 15, l. 2.

<sup>53</sup> Far West Closing Brief at 7, fn. 3.

1           *S Developers does not keep detailed job costing records for its*  
2           *overhead.*"<sup>54</sup>

3 Far West claims that approximately \$110,000 of the \$147,575 is overhead.<sup>55</sup> Without supporting  
4 documentation, the Company has not met its burden of production.

5           Far West also ignores case law that directly rejects utility's requests to include affiliate profit  
6 in its rates. For example, in *Washington Utilities & Transportation Commission v. Washington*  
7 *Water Power Company*, 24 P.U.R. 4<sup>th</sup> 427 (1978), the Washington Utilities and Transportation  
8 Commission held that "the only method of determining the fairness and reasonableness of [affiliate  
9 costs] is to determine *the reasonableness of the return to the [utility]* on their property used and  
10 useful in the business."<sup>56</sup> The court rejected the utility's effort to earn "double profits."<sup>57</sup> In the  
11 instant case, Ms. Brown testified that affiliate profit evades ROE regulation.<sup>58</sup> Consistent with  
12 *Washington Water Power Company, supra*, she also testified that affiliate profit is not needed in the  
13 provision of utility service.<sup>59</sup>

14           Finally, Ms. Capestro's testimony is almost an admission that the Company did not provide  
15 enough evidence to meet its burden of production. Ms. Capestro testified:

16                     Probably in the future we should supply to you some supporting  
17                     bids....I think that would be helpful to get that information to the  
18                     Commission....I don't think its unreasonable to give that  
19                     supporting documentation. It's time consuming to do it, but it's  
20                     not, I don't think, an unreasonable request.<sup>60</sup>

21           Not only is it a reasonable request, providing such information is necessary for the Company to meet  
22 its burden of production and persuasion.

23 ...

24 ...

25 ...

26 ...

27 <sup>54</sup> Ex. No. S-14; *Brown Surrebuttal* at 11, ll. 7-13 (emphasis added).

28 <sup>55</sup> Ex. No. A-6 at 7, ll. 3-4.

<sup>56</sup> *Washington Power Co.* at 10 (publication pages not available, page reference is to Westlaw printout) (citing *Wichita Gas Co. v. Kansas Pub. Service Commission*, 2 F Supp 792 (DC Kan 1933) (emphasis added)).

<sup>57</sup> *Id.*

<sup>58</sup> Ex. No. S-23 at 12, l. 12, to 13, l. 16.

<sup>59</sup> *Id.*

<sup>60</sup> Tr. at 69, ll. 8-22.

1 **IV. STAFF'S NORMALIZATION OF REPAIR AND MAINTENANCE EXPENSES IS**  
2 **PROPER RATEMAKING.**

3 Far West criticizes Staff's normalization of test year expenses for repair and maintenance.  
4 The Company also criticized Ms. Brown because she was "unable to explain her adjustment."<sup>61</sup> The  
5 Company does not claim that normalization is not a proper ratemaking method. Instead, it appears to  
6 claim that the facts of this case do not support normalization for repair and maintenance. The  
7 Company explains that there has simply been growth in these expenses.<sup>62</sup>

8 Even if there has been growth in these expenses, Staff's adjustment is appropriate. The  
9 Company states that the 2004 test year expenses are similar to the expenses in 2005.<sup>63</sup>  
10 Notwithstanding increases in 2004 and 2005, the adjustment is appropriate because the additional  
11 expenses requested by the Company are unreasonable and imprudent.

12 Company witness Mr. Kaveney testified that problems with its wastewater treatment facilities  
13 began in March of 2004.<sup>64</sup> He explained that the problems were caused by "substandard, fly-by-night  
14 engineers and contractors who stuck so-called wastewater plants in the ground, collected their money,  
15 and got out of Dodge."<sup>65</sup> It is not surprising that the Company did not attempt to explain the cause of  
16 the increase in repair and maintenance expense.

17 The evidence in the record is sufficient to determine the cause of the increase. Staff believes  
18 there are two causes. The increase in repair and maintenance expenses was caused in large part by  
19 problems with the Company's wastewater treatment facilities. Far West should not pass on increased  
20 costs to ratepayers for its poor selection of contractors.

21 The other cause was an increase in customers served by the Company.<sup>66</sup> In Staff Brief  
22 Schedule CSB-15, Ms. Brown accounted for customer growth in her normalization. She calculated  
23 an average per customer cost over three years using the number of customers for each year. Ms.  
24 Brown then applied that average customer cost to the number of customers in the test year.

25  
26 <sup>61</sup> Far West Closing Brief at 16, ll. 8-9 and ll. 17-22.

27 <sup>62</sup> See *Id.* at 16, fn. 9.

28 <sup>63</sup> *Id.*

<sup>64</sup> Tr. at 155, ll. 7-25.

<sup>65</sup> Kaveney Rebuttal at 8, ll. 18-20.

<sup>66</sup> See Staff Brief Schedule CSB-15, column H.

1 Staff urges the Commission to adopt its recommendation for repair and maintenance expense.  
2 Staff's normalization method appropriately balances increased costs due to customer growth while  
3 disallowing imprudent costs. Ms. Brown's normalization is fair to both ratepayers and the Company.  
4

5 **V. THE COMMISSISON SHOULD ADOPT STAFF'S RECOMMENDED CAPITAL**  
6 **STRUCTURE AND COST OF CAPITAL.**

7 Staff addresses three topics in response to the Company's Closing Brief: (1) Mr. Irvine's  
8 qualifications as an expert cost-of-capital witness; (2) Staff's recommended ROE; and (3) Staff's  
9 recommended capital structure.

10 **A. Staff witness Mr. Steve Irvine is a qualified cost-of-capital expert.**

11 Staff strongly objects to the Company's criticism of Mr. Steve Irvine as Staff's cost of capital  
12 witness. The Company questions Mr. Irvine's qualifications and his analysis of this case.<sup>67</sup> The  
13 Company's criticism is extremely inappropriate. Staff objected to Far West's questions on this issue  
14 at hearing. Administrative Law Judge ("ALJ") Teena Wolfe sustained Staff's objection.<sup>68</sup>

15 In its Closing Brief, Far West again claims that Mr. Irvine is not qualified as a cost-of-capital  
16 witness. By raising the issue again, the Company ignores Judge Wolfe's ruling during the hearing.  
17 The issue is in the record and, therefore, preserved for appeal should the Company choose to appeal.

18 Notwithstanding the argument above, Staff will address the merits of Far West's claim. The  
19 Company criticized Mr. Irvine because this case is his first case as a cost-of-capital witness. It also  
20 criticized him for working with other Staff members and using Staff tools to prepare his testimony.<sup>69</sup>

21 Mr. Bourassa testified as a cost-of-capital witness for the first time in the pending rate case for  
22 Black Mountain Sewer Company.<sup>70</sup> This case is only his second case for cost-of-capital testimony.  
23 Furthermore, the "approaches" he used in both cases are the same approaches used by Dr. Zepp. Dr.  
24

25  
26 <sup>67</sup> Far West Closing Brief at 17, ll. 12-19. See also Tr. at 483, l. 24, to 484, l. 2 ("Don't you think you lack the experience  
27 as a cost-of-capital analyst to criticize the works of a gentlemen like Dr. Zepp who has been doing cost of capital for a  
couple of decades?").

28 <sup>68</sup> Tr. at 484, ll. 3-13.

<sup>69</sup> Far West Closing Brief at 17, ll. 12-19.

<sup>70</sup> Tr. At 293, ll. 3-24.

1 Zepp has been the cost-of-capital witness in cases for which Far West's counsel was the attorney.  
2 Therefore, Staff finds the argument very disingenuous.

3 Moreover, the Company did not cite any legal authority for its argument. Arizona Rules of  
4 Evidence Rule 702 provides that an expert witness may be qualified by "knowledge, skill,  
5 experience, training, or education." In *Englehart v. Jeep Corporation*, 122 Ariz. 256, 594 P.2d 510  
6 (1979), the Arizona Supreme Court held:

7 Whether a witness is competent to testify as an expert is a matter  
8 primarily for the trial court and largely within its discretion. We  
9 will not overrule the trial judge's decision in this regard unless  
there has been a clear abuse of discretion.<sup>71</sup>

10 In *Lay v. City of Mesa*, 168 Ariz. 552, 815 P.2d 921 (App. 1991), the Court of Appeals of Arizona  
11 further explained that:

12 The purpose of expert testimony is to allow the trier of fact to  
13 receive information....which will be useful to the resolution of the  
14 dispute before it....An expert may be qualified to testify on the  
15 basis of actual experience or *careful study*. It is not necessary that  
the expert "have the highest possible qualifications or highest  
degree of skill or knowledge..." to testify.<sup>72</sup>

16 Far West made no effort to apply the law to the facts.

17 Mr. Irvine specifically testified that he has "done *extensive reading*", attended training and  
18 worked closely with more experienced Staff members.<sup>73</sup> In other words, Mr. Irvine "carefully  
19 studied" cost-of-capital theory and applications and adequately prepared his testimony. His  
20 testimony speaks for itself. However, Staff notes that Mr. Irvine competently answered every  
21 question posed to him at the hearing. Far West's argument is completely unfounded in fact or in law.

22 Every expert witness must testify for the first time on a particular topic at some point in his or  
23 her career. It is also accepted academic and industry practice for experts to rely on tools and methods  
24 developed by other experts. Mr. Irvine testified that he independently concluded that use of Staff  
25 tools and methods were appropriate for this case.<sup>74</sup> Mr. Irvine's preparation, tools and methods were  
26 appropriate and consistent with academic and industry practice. Therefore, he is qualified to provide

27 <sup>71</sup> *Id.* at 122 Ariz. 258, 594 P.2d at 512 (citations omitted).

28 <sup>72</sup> *Id.* at 168 Ariz. 554, 815 P.2d at 923 (citations and quotes omitted; emphasis added).

<sup>73</sup> Tr.. at 486, ll. 14-18 (emphasis added).

<sup>74</sup> Tr. at 508, l. 21, to 509, l. 2.

1 expert testimony on cost of capital. Staff urges the Commission to adopt Mr. Irvine's  
2 recommendations in this proceeding.

3 **B. The Commission should adopt Staff's recommended ROE, and ignore Far West's**  
4 **mischaracterization of Staff's CAPM results.**

5 Far West mischaracterizes the results of Staff's capital asset pricing model ("CAPM"). The  
6 Company claims that "Staff blindly accepts the results of its models, despite the fact that its  
7 recommended ROEs cannot be reconciled with economic reality."<sup>75</sup> Far West's argument ignores the  
8 "reality" of fundamental mathematical and financial calculations.

9 The Company presents a table with a handful of dates over a three year period. The table only  
10 includes average beta, risk-free interest rate, and Staff's ROE.<sup>76</sup> The table conveniently leaves out  
11 market risk premium. The Company then argues that the average beta and risk-free interest rate do  
12 not correlate with Staff's ROE for the few dates presented. Staff addressed this argument in its  
13 Closing Brief.

14 Staff will not repeat its arguments in total again. However, Staff repeats that the CAPM has  
15 three inputs. Even if two inputs are increasing, the resulting ROE can remain the same. The third  
16 input could decrease to offset the increases in the other two inputs. Staff has already provided  
17 evidence that market risk premiums have decreased enough to offset increases in beta and the risk-  
18 free interest rate.<sup>77</sup>

19 **C. The Commission should adopt Staff actual capital structure, and reject Far**  
20 **West's hypothetical capital structure.**

21 Far West claims that Staff recommends use of a hypothetical capital structure. Staff does not.  
22 Staff recommends use of Far West Water & Sewer, Inc.'s actual capital structure. The Company  
23 claims that the sewer division's actual capital is 100% equity because it does not have any debt.<sup>78</sup>  
24 The Company is actually proposing a hypothetical capital structure for the sewer division.<sup>79</sup>

25  
26  
27 <sup>75</sup> Far West Closing Brief at 19, ll. 13-14.

28 <sup>76</sup> *Id.* at 18, ll. 1-21.

<sup>77</sup> Staff Closing Brief at 29, ll. 15-20.

<sup>78</sup> Far West Closing Brief at 19, l. 16, to 20, l. 8.

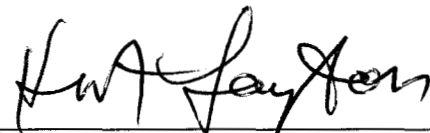
<sup>79</sup> Tr. Vol. III at 525, lien 3 to 527, line 7.. Cf. Tr. Vol. II at 320, line 1 to 321, line 6.

1 It is undisputed that all debt incurred by the Company is incurred by the corporate entity Far  
2 West Water & Sewer, Inc.<sup>80</sup> It is undisputed that the loan agreement with the Water Infrastructure  
3 Financing Authority ("WIFA") places restrictions on the entire corporation, and not just the water  
4 division.<sup>81</sup> The Company has a pending loan to finance new sewer infrastructure. It is undisputed  
5 that the potential lender required consideration of revenues from the water division for its loan  
6 analysis.<sup>82</sup>

7 The corporation's actual capital structure must be used to ensure sewer ratepayers are treated  
8 fairly. Ignoring the WIFA loan would ignore the implicit costs imposed on sewer ratepayers. Staff  
9 urges the Commission to use Staff's recommended actual capital structure.

10 Finally, the Company argues that Staff recommends a hypothetical cost of debt.<sup>83</sup> Staff does  
11 not. Staff's recommendation for a retroactive financing approval uses the actual interest rate charged  
12 by H & S Developers. As stated in Staff's Closing Brief, Mr. Irvine recommends 5.93% based on the  
13 actual interest paid to H & S Developers for Account 234 balances.<sup>84</sup> Additionally, the Company  
14 itself refers to some of the balances as loans.<sup>85</sup> It is irrelevant that the interest rates charged by H & S  
15 Developers are below current interest rates.<sup>86</sup>

16  
17  
18 RESPECTFULLY SUBMITTED this 18<sup>th</sup> day of October, 2006.

19  
20  
21 

22 Keith A. Layton, Attorney  
23 Legal Division  
24 Arizona Corporation Commission  
25 1200 West Washington Street  
26 Phoenix, Arizona 85007

27 <sup>80</sup> Ex. No. S-10 at 1 (The loan defines borrower as Far West Water & Sewer, Inc.).

28 <sup>81</sup> *Id.*; see also Section 11 at 16-17..

<sup>82</sup> Tr. Vol. I at 111, line 1 to 113, line 1.

<sup>83</sup> Far West Closing Brief at 19, l. 25, to 20, l. 5.

<sup>84</sup> Ex. No. S-26.

<sup>85</sup> Ex. No. S-24 at 13.

<sup>86</sup> Far West Closing Brief at 20, ll. 1-5.

1  
2 Original and thirteen (13) copies filed  
3 this 18<sup>th</sup> day of October, 2006 with:

4 Docket Control  
5 Arizona Corporation Commission  
6 1200 West Washington Street  
7 Phoenix, Arizona 85007

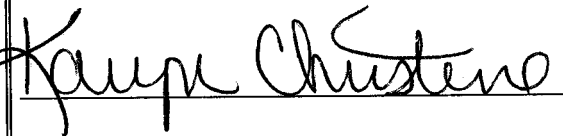
8 Copies of the foregoing were mailed  
9 on this 18<sup>th</sup> day of October, 2006 to:

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24 Murphy Campbell  
25 Far West Water & Sewer, Inc.  
26 12486 Foothill Boulevard  
27 Yuma, Arizona 85367

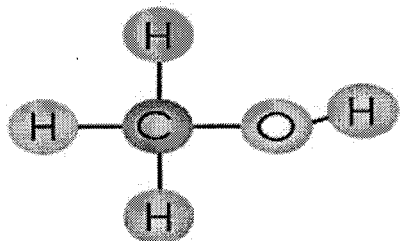
28 



# ATTACHMENT 1



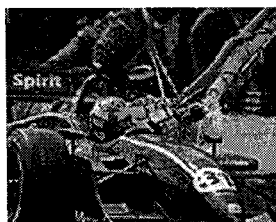
## METHANOL EMERGENCY RESPONSE



**Methanol**, also known as wood alcohol or methyl alcohol, is a colorless liquid with a faintly sweet alcohol odor. The chemical is fully soluble in water, and is readily biodegradable in both water and soil. Vapors of methanol are slightly heavier than air, and may travel some distance to a source of ignition and flash back. Accumulations of vapors in confined spaces may explode if ignited, and containers filled with methanol may rupture violently if exposed to fire or excessive heat for a prolonged duration.

Direct exposure to methanol should be avoided as methanol can be harmful if swallowed, absorbed through the skin, or inhaled. Ingestion of as little as one to four ounces can cause irreversible injury to the nervous system, blindness or death. When properly contained and handled, methanol can be a safe and effective product for a wide range of applications.

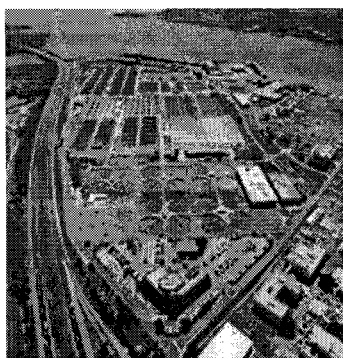
**Fire Safety:** The U.S. Department of Transportation regulates methanol as a Class 3 Flammable Liquid, with a subsidiary risk as a Class 6.1 Toxic Material. Solutions of methanol containing up to 74% water are classified as flammable. Compared with gasoline, methanol spills are harder to ignite, burn at a slower rate, and with less heat intensity. Methanol vapors must be four times more concentrated in air than gasoline vapor for ignition to occur. In fact, methanol burns just 25% as fast as gasoline, and methanol fires release heat at only one-eighth the rate of gasoline fires. Each year, about 16,000 Americans are exposed to post-crash fires in cars and other light-duty vehicles, resulting in hundreds of fatalities. According to the U.S. Environmental Protection Agency a switch to methanol fuel would reduce the number of automotive fuel related fires by 90% compared with gasoline, saving hundreds of lives each year.



Methanol flames are almost invisible in bright sunlight conditions, but they may be detected by the heat generated or the burning of other materials. Large amounts of water will remove heat and can be effective in diluting methanol to the point where most fires can be readily extinguished. To prevent fires keep open flames, sparks and oxidants away from methanol. For over three decades, methanol has been the fuel of choice for Indianapolis-type racecars in part because of its superior fire safety characteristics. When an INDY car pulls into the pit with an engine fire, pit crews simply pour water on the racecar, and the driver gets back into the race (see photos). Dry chemical powder, carbon dioxide and alcohol-resistant foam extinguish methanol fires by oxygen deprivation. Firefighters should use full-face, self-contained breathing apparatus, and wear impervious clothing, gloves and boots. For larger fires involving a

tank, rail car or tank truck, isolate for ½ mile in all directions, also consider evacuation for ½ mile in all directions. Keep any methanol containers cool by spraying with water.

**Environmental Protection:** If a methanol spill occurs, stop or reduce discharge of material if this can be done without risk. Isolate the spill or leak area immediately for at least 330 to 660 feet in all directions. Eliminate all sources of ignition, and stay upwind. Do not touch or walk through the spilled material. Prevent methanol from entering into waterways, sewers, basements or confined areas. A vapor suppressing foam may be used to reduce vapors. For small spills (up to 55-gallon drum) absorb with earth, sand or other non-combustible material and transfer to containers for later disposal.



For large spills, dike far ahead of liquid spill for later disposal, and follow local emergency protocol for handling. Spills into large natural bodies of water, such as rivers and oceans, cannot be contained. For releases into soil, surface water or groundwater, methanol has a half-life of just one to seven days, and given its high rate of biodegradation, methanol spills are not likely to persist. Methanol is used extensively in the nation's wastewater treatment facilities to reverse the damaging effects of nitrate buildup in sensitive aquifers and waterways by accelerating biodegradation.

**Personal Protection:** As a flammable and toxic chemical, caution must be exercised to avoid contact with methanol. At all times, avoid prolonged or repeated breathing of methanol vapors. Methanol should always be kept within closed systems or approved containers. Symptoms of acute methanol exposure may include headache, weakness, drowsiness, nausea, difficult breathing, drunkenness, eye irritation, blurred vision, loss of consciousness, and possibly death. Patients may improve and then get worse again up to 30 hours later. In case of methanol **contact with skin**, remove contaminated clothing, wash with soap and water for 15 minutes, and seek medical attention if irritation occurs. If methanol comes in **direct contact with eyes**, immediately flush eyes with copious amounts of tepid water for at least 15 minutes. The patient should be taken to a health care facility and referral to an ophthalmologist considered. In case of **inhalation** of methanol vapors, remove individual to fresh air. Asphyxiation from vapors may require artificial respiration. **Ingestion** of methanol is life threatening. Onset of symptoms may be delayed for 18 to 24 hours after ingestion. If patient is conscious, immediately give two glasses of water and induce vomiting. Do not make an unconscious person vomit. Transport immediately to a health care facility where standard methanol ingestion treatment can be administered.

#### Physical Properties of Methanol

Chemical Formula	CH <sub>3</sub> OH
CAS RN	67-56-1
DOT Number	UN 1230
Boiling Point	148° F
Freezing Point	-144° F
pH	7.2
Solubility	100%
Vapor Density	1.11 @ 60° F
Vapor Pressure	1.86 psia @ 68° F
Flash Point	52° F, closed cup
Density	6.63 lb. per gallon
Purity % Weight	min. 99.85

#### Hazard Summary

##### Workplace Airborne Exposure Limits

200 ppm	8-Hour Workshift
250 ppm	15-minute work period

##### Toxicological Information

LDL <sub>0</sub> Human	143 mg/kg
LD <sub>50</sub> Mouse	7300 mg/kg
LD <sub>50</sub> Rat	64,000 ppm/4 hours
LD <sub>50</sub> Goldfish	250 ppm/11 hours

**Disclaimer:** The information and recommendations herein are taken from data contained in independent, industry-recognized references including but not limited to NIOSH, OSHA, NFPA, USDOT, USEPA, and NJDHSS. Thus, the Methanol Institute makes no guarantee, warranty or other representation concerning this substance. The Methanol Institute disclaims any liability for loss or damage incurred in connection with the use of this substance. In case of any emergency, always refer to the Materials Safety Data Sheet.